THE JAPANESE FINANCIAL SYSTEM:
Restructuring for the Future*

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I was asked to talk today about the recent Japanese financial situation. As everyone is aware, the cracks in Japan's current financial stability have emerged from the market perception that Japanese banks have been dangerously weakened by a huge amount of bad loans. There is also the perception that neither the Japanese government nor the banks' managers are taking adequate measures to improve the situation, particularly against the background of Japan's deteriorating macroeconomic condition.

It is certainly true that Japanese banks have not taken decisive steps to clean up their bad assets, and indeed for many years have hesitated to disclose the true picture of their balance sheets. Banks took such incomprehensible actions because, on the one hand, they believed that business conditions would improve over the course of time thus mitigating the pain of bad loans, while on the other hand, they very much feared that drastic reform measures might destabilize the market unnecessarily. However, the situation has changed significantly since November of last

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year when both Hokkaido Takushoku Bank and Yamaichi Securities Company failed, sending shock waves across the entire Japanese economy. At that time, the Japanese government and managers of Japanese banks, forced to face the harsh economic realities, took action to strengthen the banking system through fundamental legal, institutional and financial restructuring.

Unfortunately, these new efforts have been delayed by political events. In the elections for the Upper House of the Diet which took place in July, the government party (LDP) was defeated. This outcome complicated matters, making a prompt solution very difficult. Although the LDP did enter into negotiations with the opposition parties over what form the new financial restructuring should take, the two-month process which followed was in many respects a big political show on both sides. In essence, five main issues were addressed: 1) measures to deal with troubled, but survivable banks; 2) measures to deal with failed banks that will not be able to recover; 3) ways to expedite the disposal of unknown performing loans held by banks; 4) the appropriate structure for the supervisory organization; and 5) the urgent problem of dealing with the Long-Term Credit Bank (LTCB) which was on the verge of collapse and in the midst of negotiating a merger with Sumitomo Trust Bank. Finally just two days ago, at the end of two months of negotiations, agreement on these issues was finally reached and draft legislation designed to implement the reform schemes was submitted to the Diet. Indeed, today, Friday, October 2nd, the Lower House is expected to approve those bills and send them to the Upper House. The Upper House is likely to clear them in about a week, so by the middle of October the legislation will be passed.

Although I am not familiar with the details of the agreements reached between the LDP and the opposition parties, I understand they are as follows. First, on the measures to deal with troubled but survivable banks, conditions covering the injection of public money to support and supplement the capital base of those banks will be jointly drafted. Second, failed banks with no chance of recovery will be either nationalized transitionally until they can be purchased by or merged with other banks, or they will be legally dissolved under government management or sold to the so-called "bridge bank," a government-established public bank. Third, to expedite the disposal of unknown performing loans held by banks, a new agency – the Disposal and Collection Agency – modeled after the American RTC (Resolution Trust Company) will be established. Fourth, and the decision most difficult for all concerned, is that the responsibility for dealing with bank failure and financial crisis management will be, at least for the time being, jointly born by the Ministry of Finance and the newly created Financial Restoration Committee. However, the opposition continues to demand the complete separation of the Ministry of Finance from these issues in the not too distant future. Fifth, on the LTCB issue, it was agreed that upon the request of the LTCB, the government will temporarily nationalize the bank and upon the completion of its reorganization, sell it to an interested buyer, possibly but not necessarily Sumitomo Trust Bank.

Finally, at the end of what has been a very frustrating and tedious process, I am pleased to say that we now have in place the legal, institutional, and financial framework through which to carry out a successful restructuring of the Japanese banking sector. In other words, at last we are standing at the starting line. Of course, the most difficult part of the process -- and that is the actual implementation of the scheme -- is yet to come. We should be prepared to be challenged by many tough tests in that upcoming process.

There are several tasks for us to undertake in order to make this restructuring process a success. One is, of course, to convince the general public, and also the media that a sizeable amount of public money must be spent. As you may recall, the government had originally decided to provide 30 trillion yen, but during the negotiations, there was some reshuffling of this allocation of funds. However, regardless of the amount allocated, I am certain that the government will end up having to spend tens of trillion yen to clear up this mess. How big the bill will be depends on how the overall business climate develops in the coming months.

Second, while it is obvious that effective measures are required to secure a continued flow of bank credit to the private sector thereby avoiding a deflationary impact from bank restructuring on businesses, I think this cannot be overstressed. Already we have seen the serious consequences in Hokkaido of the unintended collapse of Hokkaido Takushoku Bank last November. Indeed, in anticipation of stricter disclosure requirements, banks have already begun to shed as many loan assets as possible in order to maintain their capital adequacy ratio. In such an environment of what might be termed “corporate anorexia,” in which all banks want to reduce their weight, a serious deflationary impact on the economy is not unlikely. We must be sure to take adequate and effective measures to prevent this from happening.

Third, there is a real need to establish an effective market mechanism for facilitating the disposal of the very large amounts of collateralized assets, mainly property and others. These are the collateralized assets of bad loans held by banks. Certainly many ideas have been put forth, including securitization of assets and legal improvements to facilitate disposition. But how to expedite the disposal of those collateralized assets will be a crucial element in facilitating the reduction of bad loans.

Last but not least, it is certain that we need above all, a steady recovery of the overall economy. For that purpose, I believe that in addition to what we have done already, we need to implement further fiscal, monetary, and deregulation policies. Specifically the only way to avoid the deflationary impact of restructuring is to boost the economy by providing new business opportunities, which can in turn create new employment and new income. Deregulation is an important step in that direction.

In terms of the political side of this situation, when the LDP lost control (i.e., the majority) of the Upper House in the last election, it became absolutely necessary for them to get the support of at least some opposition parties. That is why during the negotiation process, the LDP gradually expanded its concessions to the oppositions' requests. And this situation will not be confined to financial reform legislation. All other legislation will meet with this same fate. But the opposition is also diversified: Peace and Reform, Liberals, Communists, and the leaders, the Democrats. This fragmentation creates an opportunity for the LDP to formulate partial alliances with various opposition parties on different issues. To some extent, this strategy of partial alliance worked in the financial reform negotiations. In the last stages of the negotiation, the Peace and Reform party took a more conciliatory posture with the LDP although the liberals remained very staunchly anti-government. Of course, at the same time, the opposition parties understood that their strength lies in solidarity, so they tried very hard to stay unified. Again, their efforts were successful until the very end of the negotiations, demonstrating the ability of the opposition parties to maintain at least a core of solidarity among themselves.

It is quite clear that neither the LDP nor the opposition parties wants an early election of the Lower House. For the LDP, an early Lower House election would surely mean their loss over the control of the government. Although the opposition parties appear somewhat ambivalent, my guess is that the majority of incumbent politicians do not want to face a Lower House election soon. Indeed, taking an even more cynical view, I would venture to say that at least some of the members of the opposition would prefer not to take control of the government at this very difficult time. Rather, they may well prefer to wield the power of *de facto* control over legislation.

I know that Obuchi is not a very popular prime minister, particularly in this country. But the simple fact is that under Japan's system of parliamentary democracy, he was duly elected as prime minister. There was no wrong-doing or cheating in that election, and I want to make that point clear. Of course whether or not he is a good prime minister is a different matter altogether. But he does seem to know his own strengths and weaknesses, and this is a rare quality among politicians. This means that on issues which are not his strong suit, Obuchi prefers to let better players do the job while he remains a sort of stage manager. Having learned from the mistakes of his predecessor, Obuchi is also reluctant to demonstrate strong leadership when he does not have real clout to back it up. Nevertheless, it remains true that during the financial restructuring negotiations, the LDP suffered not only from the lack of a strong command post but also as a lack of coordination between the group of younger members who actually participated in the negotiation process and the group of senior party leaders. Indeed it was the group of younger LDP members, particularly those from urban electorates so desperate to avoid an early election in order to keep their positions, who were most willing to make the necessary compromises to reach agreement with the opposition during the negotiations.

To conclude, several very interesting phenomena have emerged from this recent political negotiation experience. One is of course the fact that the Ministry of Finance and the Bank of Japan were distanced from the core of the negotiations. Clearly, there is still a very strong feeling against them both among the opposition and the LDP itself. But at the same time, I have sensed that after sober reflection, politicians, media, and business alike recognize the need for a group of cool-headed and objective experts capable of leading Japan through this period of crisis. Because of the lack of such a group, I am afraid that this entire process of negotiation was made more difficult than it should have been.

The second interesting phenomenon is the emergence of a new group of young, hardworking and quite knowledgeable politicians who gained a certain amount of confidence by being able to bring these difficult negotiations to a successful end. These younger politicians emerged in both the LDP and some of the opposition parties.

It is true that a great sense of uncertainty about Japan's future stability is shared by LDP and opposition members alike. Out of this uncertainty, we can draw several scenarios. One is the certain regrouping of political parties, the splitting of the LDP, the splitting of the Democrats, and the regrouping of the other political parties in one way or another. A second scenario is a change in government should the current political leaders fail to deal successfully with any one of a number of delicate and political issues they face, including the pending U.S.-Japan defense guideline negotiations, North Korean nuclear issues, and several upcoming visits from heads of state. But a third scenario is that the present administration will strengthen its position through the gradual accumulation of achievements, no matter how poorly these achievements are judged. I will conclude by saying that the Japanese government, Prime Minister Obuchi included, is trying really hard to meet the present challenges, but the future is wide open, and any of the above political scenarios is possible.

Discussion

Question: Governor Hayami of the Bank of Japan has announced his intention to increase by 50 percent the amount of open market operations. Mr. Sakakibara, your grandchild at the Ministry of Finance, has announced that the exchange rate is going to remain where it is. Those two policies would strike an outside observer as being incompatible. So two questions: What is your judgement about how that incompatibility will be resolved? And do you think that a modest devaluation as part of a program of expansion would be beneficial to Japan?

Gyohten: Both of those propositions – first, trying to supply adequate liquidity, and second maintaining exchange rate stability – are objectives of the present administration. Although theoretically speaking these propositions may be contradictory to each other, when you consider that the present yen-dollar exchange rate of 130 to 140 may be slightly undervalued, it is no longer true that greater liquidity and lower interest rates will be incompatible with strengthening the exchange rate. While lowering interest rates can certainly lead to weakened exchange rates, exchange rate markets are actually less affected by monetary policy than they are by more broad-gauged sentiments of economic well-being or distress. In reality, then, it may be possible to achieve both goals simultaneously. However, I don't think a devaluation would be very helpful now because what Japan really needs is not export-led growth but domestic-demand-led growth. Also, at present the yen-dollar exchange rate has great significance as a kind of bellweather of the overall Japanese economic situation. When the yen weakens, Japanese business takes this as a sign that economic conditions are deteriorating, and this will have a further adverse impact on Japanese consumer and investor confidence. Therefore, taking all of these considerations together, I for one would prefer to see stabilization of the yen-dollar exchange rate rather than any further devaluation.

Question: Why has it been so difficult to remove regulatory authority from the Ministry of Finance? Is it because of the large number of former MOF officials in the Diet and the LDP, or were there other considerations?

Gyohten: Even though I cannot speak for the opposition, my guess is that most opposition party members are concerned about the wide-spread resentment among Japanese people against bureaucrats, particularly MOF bureaucrats. In fact, many people blame the officials in MOF for encouraging the inclusive relationship shared between the LDP, business, and the bureaucracy, as well as the problems of corporate governance this relationship has created. For the opposition parties, cutting off MOF from any part of the policy making process is of the utmost importance as a symbol of their departure from the past.

Question: I have been surprised by the absence in any of the presentations at this conference, including your own, of two factors that might help the political acceptability of a bank bail out. There are two potential winners in a bailout of the banking system, the debtors who no longer have to pay their debts, and the managers and owners of the banks that are failed but not removed. So I ask, are there in fact plans to pursue debtors for the difference between the value of the loan and the collateral, and to remove the managers as well as the owners of banks that are intervened?

Gyohten: Those two issues are certainly on our agenda. I did not mention them not because they are unimportant but because time was limited. On your first point regarding follow up and prosecution of borrowers who get out of paying their debts, efforts are already being made, and indeed will be enlarged within the newly created agency, to rectify this problem. One important issue on the agenda is to strengthen legal measures for implementing this process. On the management issue, the so-called moral hazard problems are now very widely discussed. The opposition parties in particular are taking a harsh stance against the managers of failing institutions. I am also certain the Japanese public will not allow those managers off the hook so easily.

Question: Do you think the situation will come to the point where those implicated in the crisis will actually go to jail, as did those responsible for the savings and loan crisis in this country?

Gyohten: Well, I certainly cannot predict how many people will be arrested, but I can say that this issue is becoming increasingly important in Japan. Of course, whatever happens will be within the framework of existing laws and will depend on stakeholders demanding appropriate punishments for those responsible.

Question: When the financial bailout package was passed earlier this year, 13 trillion yen was allocated for buying preferred shares in existing banks. Now that entire arrangement seems to have disappeared from the new agreement. My question is what alternatives are now available for providing additional capital to the large banks which are now under even greater pressure due to the drop in the stock market. Also, what about the supposed guarantee from several Japanese government officials that none of the large banks would be allowed to fail? Is that still operational or not?

Gyohten: In hindsight, the allocation of that 13 trillion yen had limited effectiveness. Therefore that particular scheme is now being replaced by a new concept which more clearly defines the extent and format of public management based on the financial situation of the individual banks concerned. The most recent idea is to classify troubled banks according to their capital ratio and that classification will determine the amount of public money which will be injected.

Question: You have drawn a distinction between survivable banks which are going to get public capital and failed banks which are not. How does the legislation purport to make that distinction and do the shareholders in survivable banks walk away with their stake intact or enhanced?

Gyohten: We will draw the line based upon certain financial data, which will become clear after official inspection, and also by the institution's own self-assessment. In the most serious cases, the authorities will make a determination that there is no chance for the banks' survival. Other troubled banks that request public support will be placed under such scrutiny that it will be difficult for them to pass as less troubled than they really are. But in neither case should the managers responsible be allowed to go unpunished. The fat cats will not be allowed to run away, and in the end that will be the best lesson for everyone.